Back to Basics: Intercompany Transactions (and some Current Developments)

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• Intercompany Transaction Regulations: Stock of Members

• Reg. § 1.1502-13(c)(6): Elimination of certain Stock gains
Intercompany Transaction Regulations

• The purpose of Reg. §1.1502-13 “is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).”

• Balance between single entity and separate entity approach

• Unarticulated goal is to further the integrity of the repeal of the General Utilities doctrine by preventing bust-up transactions
Separate Entity v. Single Entity

Separate entity
- Amount
- Location

Single entity
- Timing
- Attributes (redetermine as if divisions of a single corporation)
  - Character
  - Source
  - Exclusion
  - Noncapital
  - Built-in

Intercompany Transaction Regulations
(Introduction)

- Basic Organization of the Regulations
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Intercompany Transaction Regulations (Definitions)

- **Intercompany Transaction**: A transaction between corporations that are members of the same consolidated group immediately after the transaction, including sales or exchanges of property, performance of services, licensing of property, loans or distributions (§1.1502-13(b)(1))

- **Intercompany Item**: S’s income, gain, deduction and loss from an intercompany transaction (§1.1502-13(b)(2))

- **Corresponding Item**: B’s income, gain, deduction and loss from an intercompany transaction, or property acquired in an intercompany transaction (§1.1502-13(b)(3))

- **Recomputed Corresponding Item**: The corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions. (§1.1502-13(b)(4))

- If S and B were divisions of a single corporation and S sold property to B, what would the basis of the property be in B’s hands? For example, if S owned land with a basis of $40 and sold the land to B (another division of the same corporation that operates the S division) for $100, what is B’s basis in the land?
Intercompany Transaction Regulations (Matching Rule)

Matching Rules (Timing and Attributes)

- Timing (Reg. §1.1502-13(c)(2))
  - B’s items
    - B takes its corresponding item into account under its accounting method, but the redetermination of the attributes of a corresponding item might affect its timing.
  - S’s items
    - S takes its intercompany item into account to reflect the difference for the year between B’s corresponding item taken into account and the recomputed corresponding item.

- \[ RCI - CI = SII \]
Intercompany Transaction Regulations (Matching Rule)

Timing of Recognition

S
Sale of land For $100
Blackacre Basis = $130

B
Sale of land For $110
Blackacre Basis = $100

A

S’s intercompany loss = Recomputed corresponding item - B’s corresponding item

Intercompany Transaction Regulations (Matching Rule)

Timing of Recognition

If B contributes Blackacre to Newco in a section 351 exchange, what is the effect on the reporting of S’s gain? What effect if there is an intercompany loss and B receives 60% of Newco’s stock?
Intercompany Transaction Regulations (Matching Rule)

Timing of Recognition

S purchases a depreciable truck on January 1 of Year 1. On January 1 of Year 3, S sells the truck to B for $130. When are S’s gain and B’s gain taken into account?

S sells land to B in Year 1. In year 3, B sells the land to A for a note. If A’s note is payable in two annual installments at the end of Year 4 and Year 5, when are S’s gain and B’s gain taken into account?
Intercompany Transaction Regulations
(Matching Rule)

Timing of Recognition

S sells land to B in Year 1. In year 3, B sells the land to A for a note. If A’s note is payable in two annual installments at the end of Year 4 and Year 5, when are S’s gain and B’s loss taken into account?
Conflict of Attributes “B drives”
Reg. §1.1502-13(c)(4)(i)

• If S and B’s items offset in amount, but the character of their attributes differ, B’s character generally controls S’s.

• Example. B borrows from S and repays the loan for a lesser amount. In a non-intercompany context, B would have ordinary COD income under section 61(a)(12) and S would have a capital loss under section 1271(a). In the case of an intercompany obligation, S’s loss is recharacterized as ordinary.

Intercompany Transaction Regulations
(Matching Rule)

Attribute Redetermination

S sells land to B in Year 1. In year 3, B distributes the land to A.
• When is S’s gain taken into account?
Intercompany Transaction Regulations (Matching Rule)

Attribute Redetermination

- S sells truck to B in Year 1. In year 3, B sells the truck to A for a note. If A’s note is payable in two annual installments at the end of Year 4 and Year 5, when are S’s gain and B’s gain taken into account?
- What is the character of the gain?

Consolidated Returns
Intercompany Transactions
Acceleration Rule
Intercompany Transaction Regulations -- Acceleration Rule

Acceleration Rules

• General Rule
  – S’s and B’s items are taken into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation

  • S or B leave the group, discontinue filing consolidated returns, etc, or

  • A non-member reflects any aspect of an intercompany transaction (e.g., contribution of asset to a partnership)

Timing of S’s items:
  – Accelerated when items cannot be matched or when a non-member reflects any aspect of the intercompany transaction

Timing of B’s items
  – B continues to take its corresponding items into account under its accounting method, taking S’s activities into account under the principles of the attribute rules contained in the matching rule

Attributes — the regulations provide mechanical rules for determining S’s and B’s attributes based on whether the intercompany transaction was a sale or exchange and whether the property remains in the group after the acceleration event. See Reg. § 1.1502-13(d)(1)(ii) and (2)(i).
Intercompany Transaction Regulations -- Acceleration Rule

Basic Acceleration Case

1. What is the effect of these transactions under the intercompany transaction regulations?
2. What if instead the partnership were wholly owned by members of the P group?

S distributes the land as a dividend to P
Thereafter, P contributes the land to a partnership that is formed with a third party

Land AB = $0
FMV = $100

Intercompany Transaction Regulations -- Acceleration Rule

Basic Acceleration Case

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Land AB = $0
FMV = $100
Intercompany Transaction Regulations -- Acceleration Rule

1. S sells asset A (which has a FMV of $100 and a tax basis of $20 in S's hands) to B for $100. Thereafter, P sells all of the stock of Holdco to X, an individual. What is the tax effect of these transactions?
2. Does it matter whether Holdco, S and B elect to file consolidated returns?
3. Does it matter whether X is the common parent of a consolidated group?

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Intercompany Transaction Regulations -- Acceleration Rule

1. S sells asset A (which has a FMV of $100 and a tax basis of $20 in S's hands) to B for $100. Thereafter, X, an individual, acquires all of the stock of P. What is the effect of these transactions under the intercompany transaction regulations?
2. Suppose X is an includible corporation that does not file a consolidated return?
3. Suppose X is the common parent of a consolidated group!
Intercompany Transaction Regulations -- Acceleration Rule

Intercompany Sale of Less-than-50% Interest in a Partnership

S sells its 40% interest in the partnership for $100. The partnership makes a section 754 election to increase the partnership’s basis in its assets for such sale. What are the consolidated return consequences?

Intercompany Transaction Regulations -- Acceleration Rule

Intercompany Sale of More-than-50% Interest in a Partnership

S sells its 60% interest in the partnership for $100. The partnership terminates under § 708(b)(1)(B). The partnership is deemed to contribute its assets to a new partnership and old partnership is deemed to liquidate. What are the consolidated return consequences?
Intercompany Transaction Regulations -- Acceleration Rule

• Section 708(b)(1)(B) causes a partnership to terminate where there is a sale or exchange of 50% or more of the total interests in the partnership.

• Reg. § 1.708-1(b)(1)(iv) provides that the partnership is deemed to contribute its assets to a new partnership in exchange for all of the interests in the new partnership. The old partnership is deemed to liquidate, distributing its interest in the new partnership to the purchaser and other partners.

• The new partnership’s basis in the property will equal the basis of the property in the hands of the old partnership under section 723. A remaining partner’s basis in its interest in the new partnership will equal its basis in the old partnership under section 732(b).

• But the partnership assets begin a new recovery period under section 168(i)(7) and partnership may make new elections. Has a non-member (i.e., the partnership) reflected any aspect of the intercompany transaction, which would cause acceleration? See Reg. § 1.1502-13(d)(1)(i)(B).

• What if an intercompany gain? What if an intercompany loss?

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Intercompany Transaction Regulations -- Acceleration Rule

Buy Out of Partnership Interest – Asymmetrical Treatment

• Rev. Rul. 99-6, 1999-1 CB 432
• McCauslen v. Commissioner, 45 T.C. 588 (1966)
• Under the ruling, S treats the transaction as a sale of a partnership interest.
• For B, the partnership is deemed to make a liquidating distribution of all its assets to S and B, and B is treated as acquiring the assets deemed to have been distributed to S in liquidation of S’s interest.
Intercompany Transaction Regulations -- Acceleration Rule

Buy Out of Partnership Interest – Asymmetrical Treatment

• How are the matching and acceleration rules applied to this asymmetrical treatment?
• Under the ruling, the asset deemed sold by S is not the same as the asset deemed purchased by B.
• Is gain or loss accelerated?
• See Reg. § 1.1502-13(c)(4) re: conflict of attributes.
• PLR 200334037, PLR 200737006
  • Rev. Rul. 99-6 applied in name only.
  • B treated as acquiring assets distributed to S in liquidation of P/S.
  • S will match B’s cost recovery on the step-up or step-down with gain recognition.

Recently Finalized Regulations under Section 267(f)
Recently Finalized Regulations under Section 267(f)

Background

- The regulations under section 267(f) provide rules that defer losses and deductions from certain transactions between members of a controlled group. Reg. § 1.267(f)-1.
- These regulations provide that the timing principles of Reg. § 1.1502-13 (governing intercompany sales or exchanges between members of a consolidated group) apply to sales or exchanges of property at a loss between members of a controlled group. See Reg. § 1.267(f)-1(a)(2). Specifically, under Reg. § 1.267(f)-1(c)(1), S’s losses and deductions are deferred until they are taken into account under the timing principles of the matching and acceleration rules of Reg. § 1.1502-13(c) and (d) with appropriate adjustments.
- However, the attribute redetermination rules set forth in Reg. § 1.1502-13(c) and (d) generally do not apply to sales or exchanges between members of a controlled group. Reg. § 1.267(f)-1(c)(2).
- Despite this general rule restricting the application of the attribute redetermination rules, Reg. § 1.267(f)-1(c)(1)(iv) contains a special rule providing that, to the extent the loss of a selling member (S) would be redetermined to be a noncapital, nondeductible amount under Reg. § 1.1502-13, but is not redetermined because of the application of Reg. § 1.267(f)-1(c)(2), the loss will be deferred and taken into account when S and the buying member (B) are no longer in a controlled group relationship.

Recently Finalized Regulations under Section 267(f)

Proposed Regulations under Section 267(f)

- On April 21, 2011, the IRS and Treasury Department issued proposed regulations under section 267(f) providing, among other things, that, for purposes of determining whether a loss would be redetermined to be a noncapital, nondeductible amount under the principles of Reg. § 1.1502-13, stock held by S, stock held by B, and stock held by all members of S’s consolidated group as well as stock held by any member of a controlled group of which S is a member that was acquired from a member of the S’s consolidated group must be taken into account. Prop. Reg. 1.267(f)-1(c)(1)(iv).
- The proposed regulations also provided an additional circumstance in which S’s deferred loss may be taken into account. Under the proposed regulations, S’s deferred loss is taken into account to the extent B recognizes any corresponding income or gain with respect to the property that is sold or exchanged. Id.
Recently Finalized Regulations under Section 267(f)

Final Regulations under Section 267(f)

- On April 16, 2012, the IRS and Treasury Department issued final regulations under section 267(f), which generally retain the rules of the proposed regulations.

- The final regulations remove the rule in the proposed regulations that allows S’s deferred loss to be taken into account to the extent B recognizes any corresponding income or gain with respect to the property. The IRS and Treasury Department acknowledged that the consolidated return provisions currently allow the loss to be taken into account to the extent of the corresponding gain and have thus determined that an explicit rule is unnecessary. The final regulations include an example Reg. § 1.267(f)-1(j) that illustrates the operation of these rules.

- The final regulations also provide that stock issued to a member of the controlled group by a target corporation is taken into account for purposes of determining whether a loss would be redetermined to be a noncapital, nondeductible amount under the principles of Reg. § 1.1502-13.

Recently Finalized Regulations under Section 267(f)

Reg. § 1.267(f)-1(i), Example 9

- P1 owns 75% of the stock of P, and P owns all of the stock of M and S. M and S each own 50% of the stock of L.
- On January 1 of Year 1, S sells 25% of L’s stock (with a basis of $80) to P1 for $50 cash and recognizes a $30 loss.
- On February 18 of Year 3, at a time when the L shares held by P1 are worth $60, L liquidates and P1 recognizes a $10 gain.

Results
- S’s loss on the sale of the L stock to P1 is deferred.
- Under the principles of § 1.1502-13, S’s loss is not redetermined to be a noncapital, nondeductible amount to the extent of P1’s $10 of gain recognized. Accordingly, S takes into account $10 of loss as a result of the liquidation.
- In determining whether the remainder of S’s $20 loss would be redetermined to be a noncapital, nondeductible amount, under Reg. §1.267(f)-1(c)(1)(ii), stock held by P1, stock held by M, and stock held by S is taken into account. Accordingly, under the principles of §1.1502-13, the liquidation of L would be treated as a liquidation qualifying under section 332, and the remainder of S’s loss would be redetermined to be a noncapital, nondeductible amount.
- Thus, S’s remaining $20 loss continues to be deferred until S and P1 are no longer in a controlled group relationship.
Recently Finalized Regulations under Section 267(f)

Reg. § 1.267(f)-1(j), Example 10

Facts
- FP (a foreign corporation) owns all the stock of FS (also a foreign corporation) and all the stock of P (a domestic corporation). P owns all the stock of T (a domestic corporation).
- In Year 1, FS contributes cash to T in exchange for newly issued stock of T that constitutes 40 percent of T’s outstanding stock.
- In Year 2, when the value of the T stock owned by P is less than its basis in P’s hands, P sells all of its T stock to FP.
- In Year 3, in a transaction unrelated to the issuance of the T stock in Year 1, T converts under state law to an LLC that is treated as a partnership for Federal income tax purposes.

Results
- P’s loss on the sale of its T stock is deferred.
- Under Reg. § 1.267(f)-1(c)(1)(iv), in determining whether P’s loss would be redetermined to be a noncapital, nondeductible amount, stock held by FS (which was acquired from T) and stock held by FP (the buyer of the T stock from P and a member of P’s controlled group) is taken into account.
- Under the principles of Reg. §1.1502-13, the deemed liquidation of T resulting from its conversion would be treated as a section 332 liquidation, and P’s loss would be redetermined to be a noncapital, nondeductible amount.
- Thus, P’s loss on the sale of its T stock continues to be deferred until P and FP are no longer in a controlled group relationship.

Intercompany Transaction Regulations

Stock of Members
Intercompany Transaction Regulations --
Stock Of Members

Stock of Members (Reg. § 1.1502-13(f))

• Intercompany Distributions
  
  – Distributee Member
    • Dividend is eliminated to recipient member provided resulting negative investment adjustment under Reg. §1.1502-32 to stock on which distribution is made. Reg. § 1.1502-13(f)(2)(ii).

  – Distributing Member
    • Section 311(b) applies to gains and losses in context of intercompany distribution. Reg. § 1.1502-13(f)(2)(iii).

Intercompany Transaction Regulations --
Stock Of Members

Intercompany Loss Distributions (Section 311): Location Preserved

What are the tax consequences to S and P if S distributes Blackacre to P and P subsequently sells Blackacre to A for $110?
Intercompany Transaction Regulations -- Stock Of Members

Intercompany Loss Distributions (Section 311)

Assume the same facts as the prior slide, except that instead of selling Blackacre to A, P subsequently distributes Blackacre to individual X at a time when Blackacre has a FMV of $70, $90 or $100?

Stock of Members

- Boot in Intercompany Reorganization (Reg. § 1.1502-13(f)(3))
  - If a member receives “boot” in an intercompany transaction that is subject to section 356, property is treated as received in a distribution separate from the reorganization
    - If section 354 applies (i.e., a reorganization), the boot is treated as received after the reorganization
    - If section 355 applies (i.e., a spin-off), the boot is treated as received before the transaction
S, which has E&P of $100, a basis of $300 and a FMV of $500, merges into B in a reorganization governed by sections 368(a)(1)(A) and (a)(1)(D). In the merger, P receives $175 of cash “boot”. What are the results? (Suppose B has a $200 gain that has not been taken into account with respect to the S stock that resulted from B’s prior unrelated distribution of the stock of S to P at a time when S had a basis of $100 and a FMV of $300?)

Reg. § 1.1502-13(c)(6)
Reg. § 1.1502-13(c)(6)

- Reg. § 1.1502-13(c)(6)(i) provides a general rule that seller’s (S) intercompany item might be redetermined under Reg. § 1.1502-13 (c)(1)(i) to be excluded from gross income or treated as a noncapital, nondeductible amount where buyer’s (B) corresponding item is excluded or nondeductible.

- However, Reg. § 1.1502-13(c)(6)(ii) provides that, notwithstanding the general rule in Reg. § 1.1502-13(c)(1)(i), S’s intercompany income or gain is redetermined to be excluded from gross income only to the extent it involves one of three specific situations:
  - B’s corresponding item is a deduction or loss and, in the taxable year the item is taken into account under Reg. § 1.1502-13, it is permanently and explicitly disallowed under another provision of the Code or regulations;
  - B’s corresponding item is a loss that is realized but not recognized under §311(a) on a distribution to a nonmember; or
  - The Commissioner determines that treating S’s intercompany item as excluded from gross income is consistent with the purposes of Reg. § 1.1502-13 and other provisions of the Code and regulations (the “Discretionary Rule”).

Intercompany Transaction Regulations

P causes S1 to make a dividend distribution of the stock of S2 to P. What are the tax consequences if P liquidates S2? Can the group alter this result? Suppose S1’s basis in the S2 stock was $225?
Reg. § 1.1502-13(c)(6)(ii)(C)

• Reg. § 1.1502-13(c)(6)(ii)(C) provides a rule under which, notwithstanding Reg. § 1.1502-13(c)(6)(ii)(A)(1), an intercompany gain with respect to member stock is redetermined to be excluded from gross income to the extent that:
  1. B or S becomes a successor to the other party (either B or S), or a third member becomes a successor to both B and S (see Reg. § 1.1502-13(j)(2) for definition of successor),
  2. Immediately before the intercompany gain is taken into account, the successor member holds the member stock with respect to which the intercompany gain was realized,
  3. The successor member’s basis in such member stock that reflects the intercompany gain that is taken into account is eliminated without the recognition of gain or loss (and that basis is not further reflected in the basis of any successor asset),
  4. The group has not and will not derive any Federal income tax benefit from the intercompany transaction that gave rise to such intercompany gain or the redetermination of the intercompany gain (including any adjustment to basis in member stock under Reg. § 1.1502-32), and
  5. The effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return.

  – For this purpose, the redetermination of P’s intercompany gain is not in and of itself a Federal income tax benefit that would preclude redetermination under this rule.

Commissioner’s Discretionary Rule (CDR)

Reg. § 1.1502-13(c)(6)(ii)(D)

(D) Other amounts.

(1) The Commissioner may determine that treating S’s intercompany item as excluded from gross income is consistent with the purposes of this section and other applicable provisions of the Internal Revenue Code, regulations, and published guidance, if the following conditions are met, depending on whether the intercompany item is an item of income or an item of gain,

  (i) In the case of an intercompany item of income, the corresponding item is permanently disallowed; or
  (ii) If the intercompany item constitutes gain, the conditions described in paragraphs (c)(6)(ii)(C)(1)(iv) and (c)(6)(ii)(C)(1)(v) of this section are satisfied.

(2) A determination by the Commissioner may be obtained only through a letter ruling request.
Reg. § 1.1502-13(c)(6)(ii)(C)

- P owns all of the stock of S1, which owns all the stock of S2
- **Steps**:
  1. S1 distributes all of the S2 stock to P in a distribution not qualifying for tax-free treatment under §355
     - Under §311(b), S1 recognizes (and defers) a $100 gain
     - Under §301(d), P's basis in the S2 stock is $100
     - S1’s gain will be taken into account under the matching rule of §1.1502-13(c)
  2. S1 liquidates under § 332, such that P inherits S’s intercompany gain on the S2 shares.
  3. S2 then liquidates under § 332.
- Under Reg. § 1.1502-13(c)(6)(ii)(C), the $100 intercompany gain is redetermined to be excluded from gross income.

Reg. § 1.1502-13(c)(6)(ii)(C) Nonmember Stock Example

- F is a controlled foreign corporation.
- **Step 1**: S distributes the F stock to P. S realizes but does not take into account the $20 section 311(b) gain.
- **Step 2**: In a later unrelated transaction, S liquidates into P under section 332. P succeeds to the $20 section 311(b) gain.
- **Step 3**: F liquidates into P in a section 332 transaction.
- Reg. § 1.1502-13(c)(6)(ii)(C) does not permit the intercompany gain to be automatically redetermined as excludable from gross income.
- However, taxpayers may request a ruling under the CDR to exclude the gain if the conditions provided in the regulations are satisfied. Other income or gain from the transactions (e.g., inclusion of the all-E&P amount) must be recognized.
Application of the CDR

- Each of Seller 1 and Seller 2 has a deferred gain as a result of a prior intercompany sale of property to Buyer.
- The property that was the subject of the prior sales exists as a block of stock (“Block 2 Shares”) that Buyer owns in Seller 1.
- Buyer merges into a disregarded entity of Seller 1.
- Because Seller 1 acquires its own stock in the transaction, the merger results in the elimination of the basis in the Block 2 Shares. Reg. § 1.1502-13(f)(4).
- The merger does not result in a successor asset to the Block 2 Shares. See Reg. § 1.1502-13(j)(1).
- As a result of the merger, Seller 1 and Seller 2 each takes into account its intercompany gain.
- Seller 1’s intercompany gain is redetermined to be excluded from gross income under the CDR.
- PLR 201210018